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Keynes and the Great Depression

While there was no single cause of the Great Depression, Keynes view on the Depression is the clearest illustration of what happened. Even though Keynes and other economists differ greatly in opinion, even some of his biggest rivals agreed that “hoarding money” did not lead to a desirable outcome. While we will talk mostly about Keynes’ view of the great depression, these principles apply to depression as a whole.

Keynes theory on why the Depressions start

Keynes believed that the path to depression, including the Great Depression is a cycle rather than a single event. As the money supply decreases, people will be more likely to hold on to their money. This starts a chain reaction. People save money which lowers the money supply even more which leads to more saving or “hoarding” as Keynes puts it. If money is not being spend there is not a way to increase the money supply.

Keynes knew that businesses might not respond to the drop in interest rates

During the Great Depression, interest rates were dropping rapidly. While normally the lower interest rates would cause businesses to invest more, the fear of not being able to recover the investment in the long term was great enough that the majority business instead held on to their money. In his book, The General Theory of Employment, Interest and Money, Keynes explains how these kinds of self-correcting mechanisms are unlikely to occur in extreme conditions because they require an optimistic outlook.

Keynes solution Depression

Keynes knew that consumers were not likely to be the source of the much needed influx of money to the economy during the Great Depression. So Keynes proposed that the Fed do that spending instead. If the fed were to have started buying bonds, this would have “Primed the pump”, as Keynes stated. The influx of money to the economy would mean more money in the hand of the people. The opportunity cost of saving money would have been much greater which would incentivize businesses to invest or buy new equipment. Consumers would be more likely to by houses or other durable goods which would have stimulated the economy of depression.

Why Keynes was right

Keynes fully believed that by injecting money into the economy was the way to end the depression. Well that is exactly what happened. In the early 40’s the government began streaming money into the economy to prepare for the events of World War II. This put more money in the hands of businesses and consumers. Spending increased and the economy stabilized very rapidly.

Why Keynes’ “Pump priming” theory doesn’t always work

Simply shoving money into the economy is not a cure-all solution to economic recession and sometimes can be the cause. While it may have been what helped recover the economy in the 40’s. It requires careful supervision. Take the recession in 2008 for example, banks were loaning money left and right. And while yes the Nominal GDP increased because a lot of people were buying houses, the market essentially crashed again because of the same cycles mentioned before. As times got rougher people got scared and starting saving money and not spending it. The supply of money decreased significantly and people were unable to pay back their loans so they defaulted. Is it possible that similar influx of money in the late 20’s caused the depression in a similar way?

Conclusion

Keynes has shown us that spending money can be a great solution to depression if regulated. In many countries adopted a Keynesian policy after WWII. If learn from him and see how his solutions worked and didn’t work in the past then we can find better ways to improve our economy.